UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

COMPTROLLER

JUN 8 2003

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (ACQUISITION, TECHNOLOGY AND LOGISTICS)
UNDER SECRETARY OF DEFENSE (PERSONNEL AND READINESS)
INSPECTOR GENERAL OF THE DEPARTMENT OF DEFENSE
DIRECTORS OF THE DEFENSE AGENCIES
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)

SUBJECT: Guidance on Prior-Period Adjustments

The new Federal Accounting Standards Advisory Board Standard No. 21, Reporting Corrections of Errors and Changes in Accounting Principles, expands and clarifies previous guidance in the Statement of Federal Financial Accounting Standard No. 7. It also substantially changes some of the previous guidance. The attachment provides guidance to implement the changes.

The attached guidance addresses: determining when a prior-period adjustment is appropriate and when it is not, calculating materiality related to a prior-period error or misstatement, reporting prior-period adjustments, and requesting approval for posting the adjustment.

My point of contact for this matter is Mrs. Mary Braun. She may be reached by e-mail at: braunm@osd.pentagon.mil or by telephone at (703) 693-6505.

Dov S. Zakheim

Attachment:
As stated

Prior Period Adjustments

Purpose. The purpose of this paper is:

- to provide guidance on when it is appropriate to make a prior-period adjustment,
- to establish guidelines for materiality as it pertains to prior-period adjustments, and
- to document requirements to request approval of a prior-period adjustment.

References.

- Statement of Federal Financial Accounting Standards No. 21
- GAO/PCIE Financial Audit Manual: Volume 1, Section 200

Discussion.

When is a prior-period adjustment appropriate?

A prior-period adjustment is appropriate when an error or the sum of an aggregate of errors made in a prior period is discovered and the error:

- **materially** misstates the prior-period or current-period financial statements if a correction is not made[1] and
- makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the inclusion or correction of the item.[2]

The Federal Accounting Standards Advisory Board (FASAB) requires that reporting entities restate prior period financial statements for material errors discovered in the current period, if such statements are provided for comparative purposes, and if the effect of the error would be material to the financial statements in either period.[1]

When material errors are discovered after the issuance of financial statements, all statements presented must be restated at year-end.[1] To correct the error, correct any individual amounts on the financial statements in the earliest affected period that is presented.[3]

When is a prior-period adjustment not appropriate?

Prior-period adjustments are not made when an error or misstatement is discovered that does not materially misstate the financial statements. In such cases, post a correcting adjustment as a current-year transaction to current-year accounts.

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[1] Statement of Federal Financial Accounting Standards (SFFAS) No. 21, paragraph 5.
[2] GAO/PCIE Financial Audit Manual, Volume 1, Section 200, paragraph 230.01.
[3] SFFAS No. 21, paragraph 10.

Prior-period adjustments are not made when an accounting principle changes unless otherwise specified in the transition instructions of a new accounting standard.[4] Unless otherwise specified, for all changes in accounting principles that would have resulted in a change to prior period financial statements:

- Report the cumulative effect of the change on prior periods as a "change in accounting principle." Adjust the beginning balance of cumulative results of operations in the Statement of Changes in Net Position for the period in which the change is posted (current year transaction).
- Present prior-year financial statements without the change for comparative purposes.
- Disclose the nature of the change in accounting principles and its effect on relevant balances in the current period footnotes. Financial statements of subsequent periods need not repeat the disclosure.[5]

Prior-period adjustments may be made if there has been a change in accounting methods from an unacceptable method to a generally accepted method and the change resulted in a material difference in the financial statements. If the change did not have a material effect on the financial statements, the change should be disclosed in the footnotes.

If an account balance changes because a valuation method has changed, footnote the change in valuation method only. Do not make a prior period adjustment, and do not restate prior period statements.

What constitutes materiality?

Materiality represents the magnitude of an omission or misstatement of an item in a financial report of a reportable entity that makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.[2]

Materiality must be calculated against a materiality base.[6] For example:

- if the misstatement is in an asset account, the materiality base could be total assets;
- if the error is in an expense account, the materiality base could be total expenses;
- if the misstatement is in a liability account, the materiality base could be total liabilities as opposed to total liabilities plus total net cost of operations.

The materiality base should be net of intragovernmental balances on the books of the reportable entity. [7]

For Department of Defense reporting entities, an omission or misstatement is considered material if it is one per cent or more of its materiality base.[8] Each DoD reporting entity should

[4] SFFAS No. 21, Executive Summary paragraph V and Statement paragraph 7
[5] SFFAS No. 21, paragraph 13
[6] GAO/PCIE Financial Audit Manual, Volume 1, Section 200, paragraphs 230.08 - 10
[7] IG, DoD November 13, 2002 memorandum on Prior Period Adjustments
[8] OUSD(C) A&FP&A chose this criteria based on GAO/PCIE, paragraphs 230.11 and 245.02

calculate materiality separately. For purposes of this guidance, an entity is considered a reporting entity if it publishes financial statements for audit.

What are the procedures for posting a prior-period adjustment?

If a DoD reporting entity discovers a material error or misstatement after the financial statements they affect have been issued, the entity must obtain approval to post a prior-period adjustment. If a prior-period omission or misstatement is material enough to warrant a prior-period adjustment, provide the following to Defense Finance and Accounting Service–Arlington (DFAS-AR) to obtain approval:

- documentation sufficiently substantive to support an audit,
- an explanation of how the amount was determined to be material,
- an explanation of what caused the omission or misstatement,
- a statement of what the original entries were, what the original entries should have been, and the proposed correcting entries in both system general ledger accounts and corresponding USSGL accounts, and
- documentation showing coordination with the entity's auditors.

Each DoD entity will need to include a sufficient display and disclosure of information of these prior period adjustments in the respective footnotes to the financial statements to adequately avoid misleading the reader.

Upon approval, DFAS-AR will forward the adjustment package to the appropriate DFAS center for posting.

The OUSD(C), Director, Accounting and Finance Policy and Analysis (AFPA) will be the final arbiter in case of dispute.